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SUBJECT: LNG Expansion - Fujian Readies for Operation of South China's Second LNG Terminal

REF: Guangzhou 007

11. (U) Summary: A delivery from Egypt marked the official opening of Fujian's new liquefied natural gas (LNG) terminal. Supply to domestic users will begin in mid-late June. Success has been tempered by the real world: rising international prices and difficulty finding reliable long-term suppliers have led to the indefinite postponement of planned expansion. Nevertheless, the province continues to promote the use of natural gas, particularly for power generation. End summary.

Up and Running

12. (U) China's second LNG receiving terminal has commenced preliminary operations in Fujian Province. The terminal, which was formally proposed in 2002, has been under construction since December 2004, when state-owned CNOOC Oil Base Group Ltd., the third-largest oil and gas company in China, and Fujian's provincial government received final approval for the project from the National Development and Reform Commission (NDRC). A joint venture between CNOOC and the U.S.-based Air Products and Chemicals, Inc. invested RMB 6.2 billion (USD 898 million) in Phase I of the project. Located in Putian city, the 40-hectare facility includes two LNG tanks and a LNG receiving terminal, which is nearly 100% complete. Two additional tanks are planned for future construction. A natural gas pipeline is 90% complete. While operation testing and phased commissioning have begun, official supply delivery to end-users is not expected until mid-June.

Expanding Fujian's Power Supply

13. (U) The Fujian LNG project will supply LNG to three power plants, and natural gas to five municipalities. The three power plants are located in Putian, Jinjiang and Xiamen. Upon completion of the three plants around 2010, total capacity is expected to be 3.5 million kilowatts, which will account for 10% of Fujian's total installed capacity. In addition to supplying power plants, the Fujian LNG project has signed contracts to supply natural gas to five cities: Fuzhou, Putian, Xiamen, Zhangzhou, and Quanzhou - all of which are promoting the conversion of household appliances, such as stoves and water heaters, which use liquefied petroleum gas

(LPG), to LNG-use equipment. The Fujian LNG project will be China's first LNG facility to recapture cold energy during regassification. The cold energy will be used to produce industrial gas products, such as liquid oxygen, nitrogen, and argon.

Securing International LNG Sources

14. (SBU) According to Fujian LNG Construction Planning Office Deputy Director Huang Shulin, expansion plans for the second phase of the LNG plant, which include increasing annual capacity to 5 million tons, have been put on hold indefinitely due to challenges in securing scarce LNG sources. One of the largest obstacles is rising international market prices. CNOOC-Fujian LNG, Co. General Manager Zhang Hao complained to us the international market price for LNG had skyrocketed since last year on the spot market. While he acknowledged that the rising price of crude oil plays a role, he argued that the spot-market prices were artificially inflated because many Asian countries are currently reluctant to sign long-term contracts for LNG. Zhang believes that if more countries would shift to the long-term market, it would decrease the appearance of demand, thereby reducing prices and eventually restoring a buyer's market for LNG.

15. (SBU) In addition to price, the Fujian LNG project faces the challenge of finding reliable long-term suppliers. In September 2002, the CNOOC - Fujian LNG, Co. signed a 25-year contract with the Indonesian Tangguh natural gas field. The Tangguh gas field agreed to supply the Fujian terminal with 1.6 million tons of LNG per year,

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an amount that will gradually increase to 2.6 million tons annually by 2013, and will account for 3-4% of Fujian's energy mix. Delays in the development of the Tangguh natural gas fields have delayed the initial delivery date of supply to Fujian, forcing CNOOC-Fujian LNG Co. to buy on the spot market.

16. (SBU) On April 26, the Fujian terminal received its first spot-market LNG shipment from Egypt's Idku LNG plant. General Manager Zhang told us that in order to stay on schedule with plans for commissioning and adherence to local distribution contracts, the terminal is in need of two to three additional spot-market acquisitions before the end of the year. Because CNOOC headquarters in Beijing negotiates supply contracts, Zhang said, he doesn't know what country might supply the additional LNG; the Fujian project management simply sends its LNG demand requests to Beijing, and awaits notification regarding future suppliers. Fujian's LNG terminal is expected to start delivering natural gas to local end users by mid-June.

Promoting Domestic Use of Natural Gas

17. (SBU) While coal remains the cheapest and most widely used fuel in Fujian province, the provincial government is looking to expand use of renewable and cleaner energy sources, including hydropower, solar power and natural gas. Unlike the situation in Guangdong province (reftel), where residential demand for natural gas is expected to equal industrial demand, the Fujian terminal's General Manager Zhang projects that industrial demand will account for 80% of the terminal's supply, while the residential use will consume 20%. In the long-term, the CNOOC-Fujian LNG Co. plans to expand distribution to both northeast Guangdong and Zhejiang provinces.

18. (SBU) Zhang explained that Fujian's efforts at promoting natural gas consumption by signing long-term contracts (between 20-25 years) with local customers have faced challenges that mirror the difficulties it has faced on the international supply market. According to Zhang, the Fujian LNG plant's domestic customers, including three power plants and five municipal gas companies, are not accustomed to signing such long-term contracts and are reluctant to enter such binding commitments. Zhang questioned whether domestic buyers would honor such contracts even if they could be convinced to

sign.

19. (SBU) The Fujian government is also facing difficulty acquiring land for construction of pipelines necessary to expand natural gas usage. It recently halted construction of the Fujian Natural Gas Pipeline, which spans the province from Quanzhou in the south to Fuzhou in the north. With limited land resources, other projects such as railway construction, highway expansion, and other fuel transmission projects have been formidable competition for pipeline as well as power plant construction. In spite of the delays, General Manager Zhang expects the pipeline to be finished by the end of the year, completing Phase I of the Fujian LNG project.

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